The Future of Sustainability Reporting: Trends to Watch
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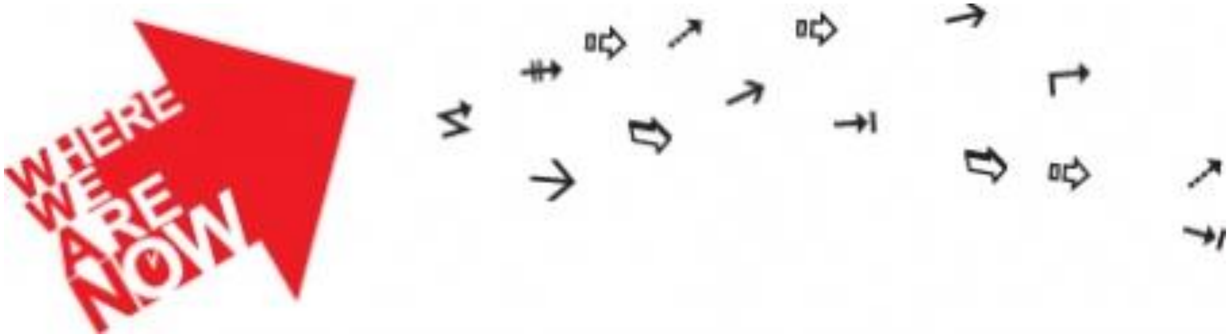
Public Company Sustainability Reporting: Regulatory Issues and Trends

Dan Goelzer
BakerMcKenzie, Washington, DC

Sustainability Reporting in the United States

- U.S. public company ESG or sustainability disclosures have increased sharply during the last several years. Most sustainability disclosure is voluntary, and much of it is outside of SEC filings.
- As investors become more focused on sustainability, they are raising questions about the quality and consistency of this disclosure.
- Companies are also beginning to recognize the risks associated with informal disclosures that are not subject to the same controls traditional financial disclosure.
- For most ESG issues, the SEC relies on the concept of materiality, rather than specific disclosure requirements. While this is unlikely to change in the near-term, the Commission may become more active in requiring companies to disclose material ESG information.

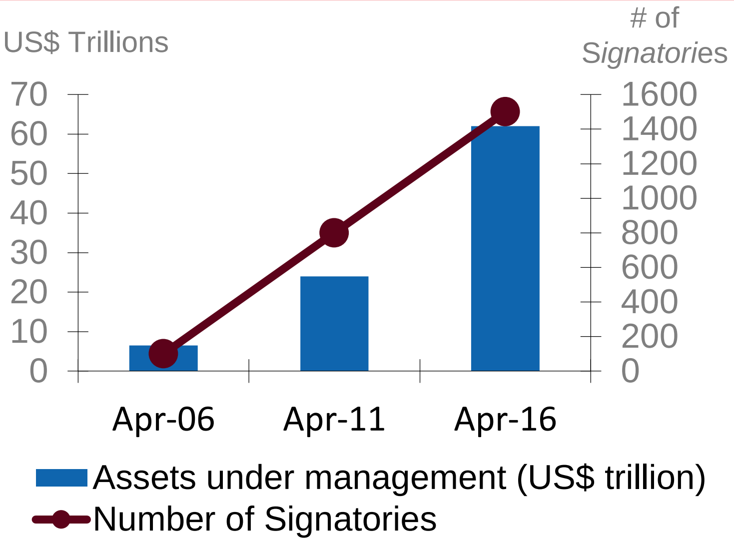
The Current State of Sustainability Reporting



U.S. Public Company Sustainability Reporting is Rising Rapidly

Investors Care About Sustainability

A rapdily increasing share of institutions manage assets with ESG issues in mind.



PRI signatories commit to:

Incorporate ESG issues into investment analysis and decision-making processes.

Be active owners and incorporate ESG issues into their ownership policies and practices.

Seek appropriate disclosure on ESG issues by the entities in which they invest.

- 89% of the world's top 100 asset managers are signatories to the Principles for Responsible Investment (PRI), including Blackrock, Vanguard, SSGA, Fidelity Investments, JP Morgan and PIMCO.
- 304 asset owners are PRI signatories, representing USD 16.6 trillion in assets.

Sources: PRI; 2016 Investment & Pension Europe; SASB

SASB: The State of Disclosure 2017

- **73 percent** of public companies are already addressing in their SEC filings nearly three-quarters of the disclosure topics SASB identified for their industry.
- **42 percent** of these companies are providing disclosure on *all* SASB disclosure topics.
- However, more than **50 percent** sustainability-related disclosures in SEC filings use generic boilerplate language.

Investors Are Unhappy With Current ESG Disclosure

Most corporate sustainability reporting does not meet investor needs.

	% Investors Dissatisfied
Disclosure of ESG-related risk/opportunity that could affect business models	93%
How sustainability risks/opportunities are identified and quantified in financial terms	82%
Ease of comparing peer companies based on ESG data disclosed	92%
Key performance indicators related to each identified material issue	68%
Use of standards for disclosure of ESG data to investors (50% want industry-specific)	71%

Sources: EY, *Is your non-financial performance revealing the true value of your business*, 2017;
PwC, *Sustainability Goes Mainstream, May 2014*; *ESG Pulse*, 2016.

Investor ESG Frustrations

Investor Needs

VS.

Issuer Reporting

Investor confidence in the quality of the ESG information received from issuers

29%

Issuer confidence in the quality of the ESG information reported

100%

GLOBAL INSTITUTIONAL INVESTORS

89% Will request sustainability information directly from the company

67% More likely to consider ESG information if common standards used

50% “Very likely” to sponsor or co-sponsor a shareholder proposal

Sources: PwC 2014, PwC *ESG Pulse,* 2016, SASB.

Risks Associated with Sustainability Disclosures

- Inaccurate disclosure.
- Inconsistent disclosure.
- Disclosure that can not be substantiated.

- Sustainability reporting is undertaken to burnish the company's reputation for good corporate citizenship. But, sustainability reporting that turns out to be untrue or inconsistent with company behavior can do significant reputational damage.
- Many companies assume that sustainability reports and other statements about ESG that are not part of SEC filings don't involve much legal risk. However, there can be securities law and other liability based on sustainability disclosures that is materially incomplete or inaccurate, regardless of whether it is filed with the SEC.

Sustainability Reporting and the Securities Laws

The SEC's Approach to Sustainability Disclosure

- Materiality controls. The SEC's approach to sustainability disclosure is largely principles, not rules, based: The Commission has relied on the concept of materiality, rather than explicit disclosure requirements, as the touchstone for sustainability disclosure.
- Limited guidance. Determining what ESG issues are material with respect to a particular company's business requires the exercise of judgment. What is disclosed and how it is disclosed varies from company to company. The SEC has issued only limited guidance (in the area of climate change) and has brought few enforcement actions.
- Narrow rules. As a result of litigation in the 1970s, the SEC has narrow rules requiring disclosure of environmental compliance costs. Congress has also imposed some ESG disclosure requirements in specific areas.

Statutory ESG Disclosure Requirements

Congress has required the SEC to adopt some disclosure requirements regardless of materiality.

- Conflict Minerals
- Mine Safety
- Resource Extraction Payments
- CEO Pay Ratio Disclosure
- Iran Sanctions Act

The Role of Materiality

What is material? The Supreme Court has told as that --

- Information is material if there is a substantial likelihood that a reasonable investor would attach importance to it in determining whether to buy or sell the securities or vote a proxy. TSC Industries, Inc. v. Northway (1976)
- Undisclosed information is material if disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of available information. (TSC)
- The materiality of an event that may occur in the future depends on weighing the probability of occurrence against the magnitude of the effect on the company if the event occurs. Basic v. Levinson (1988).

When is there a Duty to Disclose Material Sustainability Information?

Companies are not necessarily required to disclose all material facts, unless a rule requires the disclosure or statements that are made would be materially incomplete or misleading without the added facts.

Some required disclosures could be materially misleading without discussion of relevant ESG information. For example --

- The description of the company and its business (Item 101 of Reg.S-K).
- Legal proceedings (Item 103 of Regulation S-K).
- Risk factors (Item 503(c) of Regulation S-K).
- Management’s discussion and analysis (MD&A -- Item 303 of Reg. S-K).

Management's Discussion & Analysis

The SEC's MD&A requirement calls for management to provide investors with a view of the financial position and results of operations of the company through management's eyes.

- MD&A disclosures must include known trends and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance in the future.
- Two step test to determine whether there is a duty to disclose.
  - ➢ Is the the trend or uncertainty reasonably likely to occur?
  - ➢ If so, can management conclude that it will not have a material effect?

Climate Change and SEC Disclosure

Guidance Regarding Disclosure Related to Climate Change (Release No. 33-9106, February 2, 2010). Existing SEC disclosure requirements (e.g., MD&A, risk factors, description of the business, legal proceedings) may require public companies to discuss matters related to climate change. The SEC guidance discusses four topics that may trigger disclosure:

- The impact of climate change legislation or regulation.
- The impact of international climate change accords.
- Indirect consequences of climate change regulation or business trends.
- The physical effects of climate change.

Is the SEC Likely to Require Sustainability Disclosure?

In the near-term, Congress is unlikely to compel the SEC to adopt broad ESG disclsoure requirements.

However, as part of a 2015 review of its disclosure rules, the SEC raised the possibility of requiring ESG disclosure.

- Of the Concept Release's 92 Federal Register pages, only 4 pages discuss ESG disclosure. Despite this, two-thirds of the 276 non-form letter comment letters address sustainability.
- 80 percent of these letters support improved sustainability-related disclosures in SEC filings; 10 percent opposed such disclosure; and 10 percent discussed but did not support of oppose improved ESG disclosure guidance.

The Sustainability Accounting Standards Board

Accounting for a Sustainable Future

SASB's Mission

SASB's mission is to develop sustainability accounting standards that help SEC reporting companies disclose material, decision-useful information to investors in a cost-effective way.

- Recognizing that what is material varies depending on the company's business, SASB's standards are industry- specific.
- SASB identifies the sustainability topics that are material to companies in a particular industry and promulgates specific measures (metrics) of company performance or exposure with respect to those topics.

SASB and Materiality

SASB's standards are intended for use in mandatory SEC filings such as the Form 10-K and 20-F.

- SASB disclosures are designed to dovetail with the SEC's rules, particularly the MD&A requirements.
- While SASB believes that the topics addressed in its standards are material under existing securities law disclosure requirements, each company must decide materiality for itself.

In essence, SASB's standards bridge the gap between the SEC's principles-based reliance on materiality and the need for consistency and comparability in company sustainability disclosure.

SASB Disclosure Topics Example

Health Care sector

	Biotechnology & Pharmaceuticals	Drug Retailers	Medical Equipment and Supplies	Health Care Delivery	Health Care Distributors	Managed Care
Environment	• Energy Management • Water and Wastewater Management • Waste and Hazardous Materials Management	• Energy Management	• Energy Management • Water and Wastewater Management • Waste and Hazardous Materials Management	• Energy Management • Waste and Hazardous Materials Management • Climate Impacts	• Energy Management	• Climate Impacts
Social Capital	• Access and affordability • Customer Welfare • Human Rights • Selling Practices and Product Labeling	• Customer Welfare	• Access and Affordability • Selling Practices and Product Labeling	• Access and Affordability • Customer Welfare • Selling Practices and Product Labeling	• Customer Welfare	• Access and Affordability • Customer Welfare • Selling Practices and Product Labeling
Human Capital	• Employee Recruitment, Engagement, and Diversity • Employee Health, Safety and Wellbeing			• Employee Recruitment, Engagement, and Diversity		
Business Model	• Product Quality and Safety • Product Design and Lifecycle Management • Supply Chain Management	• Data Privacy & Security • Product Quality & Safety • Supply Chain Management	• Product Quality and Safety • Product Design and Lifecycle Management • Supply Chain Management • Materials Sourcing	• Data Privacy and Security	• Product Quality and Safety • Product Packaging and Distribution • Product Design and Lifecycle Management	• Rate Structure and Pricing • Data Privacy and Security
Leadership & Governance	• Business Ethics		• Business Ethics	• Business Ethics	• Business Ethics	

Global Trends: The EU Non-Financial Reporting Directive

Sustainability reporting is a worldwide phenomenon. Disclosure requirements in other jurisidictions may affect the attitudes of U. S. regulators and U.S. companies.

The EU Non-Financial Reporting Directive is a good example.

- The Directive was issued in 2014 and requires the EU Member States to implement its provisions by the end of 2016.
- While the specifics vary from country to country, the effect is require large EU-based public companies to comply with sustainability reporting requirements.

Global Trends: The EU Non-Fiancial Reporting Directive (continued)

The Directive requires reporting by undertakings with more than 500 employees that are also public interest entities (PIEs). PIEs include companies with securities that trade on an EU exchange and certain financial institutions. These companies are --

- Required to report on environmental, social and employee-related, human rights, anti-corruption and bribery matters;
- Required to describe their business model, the policies pursued by the company in relation to the non-financial matters, the outcome of these policies, the principal risks relating to non-financial matters, and how the company manages those risks.

Conclusion

- Most large U.S. public companies make sustainability disclosures. But these disclosures tend to be generic and not decision-useful for investors.
- The SEC has few specific requirements that apply to sustainability disclosures. The SEC relies primarily on the general concept of materiality. This principles-based approach is rooted in the fact that what is significant to a reasonable investor varies from company to company.
- However, this approach has resulted in a the lack of comparable, quantitative information regarding ESG risks and opportunities. This issue is more likely to be solved by companies and investors reaching a consensus on disclosure standards based on materiality, rather than by legislation or detailed SEC rulemaking.

Baker McKenzie.

Daniel Goelzer
Senior Counsel
Washington, DC

815 Connecticut Avenue, NW
Washington, DC 20006

T +1 202 835 6191
daniel.goelzer@
bakermckenzie.com

Dan Goelzer is a Senior Counsel in the Firm's Washington, DC office. He has more than 40 years of securities law experience, including service in senior positions at both the Securities and Exchange Commission and the Public Company Accounting Oversight Board. He advises clients on securities law disclosure and other SEC regulatory issues, on directors' responsibilities and corporate governance matters, and on auditor regulation. He is also a member of the Sustainability Accounting Standards Board.

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